Final Recommendation on the 14 February 2014 MPOC Change Request

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GAS INDUSTRY COMPANY LIMITED

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About Gas Industry Co.

Gas Industry Co is the gas industry body and co-regulator under the Gas Act. Its role is to:

- develop arrangements, including regulations where appropriate, which improve:
  - the operation of gas markets;
  - access to infrastructure; and
  - consumer outcomes;
- develop these arrangements with the principal objective to ensure that gas is delivered to existing and new customers in a safe, efficient, reliable, fair and environmentally sustainable manner; and
- oversee compliance with, and review such arrangements.

Gas Industry Co is required to have regard to the Government's policy objectives for the gas sector, and to report on the achievement of those objectives and on the state of the New Zealand gas industry.

Gas Industry Co's corporate strategy is to 'optimise the contribution of gas to New Zealand'.

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Executive summary

Maui Development Limited (MDL) submitted a proposed change to the Maui Pipeline Operating Code (MPOC) to Gas Industry Co on14 February 2014 (Change Request). It mostly relates to arrangements for MDL buying and selling gas to manage the inventory of gas in the pipeline (linepack). Information on the Change Request and the process for assessing it can be found on Gas Industry Co's website at www.gasindustry.co.nz.

Gas Industry Co has a contractual role under the MPOC to consult with stakeholders on each MPOC change request and determine whether or not to support it. A change request proceeds only where required by law or where Gas Industry Co makes a recommendation that supports it.

Gas Industry Co invited submissions on the Change Request on 17 February 2014. We considered the Change Request and matters raised in submissions in a Draft Recommendation dated 21 March 2014. The Draft Recommendation supported the Change Request but acknowledged concerns expressed by a number of submitters regarding the proposed addition of the underlined words to section 3A (Balancing Principles) of the MPOC:

> 3A.4 MDL will:
>
> (a) instruct the Balancing Agent to use all reasonable endeavours to buy and sell Balancing Gas in accordance with <u>MDL's published terms and conditions and</u> the following principles:
> …

Submitters considered that the addition of the underlined words could open a window to agreements outside of the MPOC dictating balancing arrangements. Our analysis did not support that view, but we encouraged submitters on our Draft Recommendation to critique that analysis and give examples of how their concerns might play out.

MDL subsequently notified us that it is prepared to remove these words. We invited the MPOC signatories to advise us if they agreed that the words could be removed from the Change Request. One party did object to the removal of the words, so we proceeded to consider the Change Request as originally submitted.

On consideration of submissions on the Draft Recommendation, we conclude that the inclusion of words in section 3A.4(a) does raise valid concerns. However, we consider those concerns are not sufficient for us to reject the Change Request, particularly when they are seen in the context of on-going changes to the MPOC balancing arrangements as the balancing arrangements continue to evolve.

Our Final Recommendation is to support the Change Request.

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1 Introduction

1.1 Purpose

This Final Recommendation considers the Maui Pipeline Operating Code (MPOC) Change Request submitted by Maui Development Limited (MDL) on 14 February 2014 and submissions received on our Draft Recommendation supporting the Change Request.

1.2 Proposed change

The Change Request mostly develops/clarifies previous change requests, in particular:

- the 5 October 2009 Change Request concerning trading hubs and notional welded points, that Gas Industry Co supported and that is now adopted into the MPOC;
- the 13 October 2011 Change Request proposing the introduction of back-to-back (B2B) balancing[1], that Gas Industry Co supported but is yet to be adopted into the MPOC; and
- the 28 March 2013 Change Request, tidying up various provisions, that Gas Industry Co supported and that is now adopted into the MPOC.

However, some submitters on the Change Request believe that a few of the proposed edits have wider significance, which Gas Industry Co ought to consider in its analysis.

1.3 Process to date

On 17 February 2014, Gas Industry Co notified stakeholders of the Change Request and invited submissions. The nine submissions on the Change Request are considered in our Draft Recommendation, dated 21 March 2014. The Draft Recommendation supports the Change Request, but acknowledges the concerns expressed by a number of submitters regarding the proposed addition of the underlined words to section 3A (Balancing Principles) of the MPOC:

> 3A.4 MDL will:
>
> (a) instruct the Balancing Agent to use all reasonable endeavours to buy and sell Balancing Gas in accordance with **<u>MDL's published terms and conditions and</u>** the following principles: …

[1] Back-to-back balancing refers to arrangements that allocate Balancing Gas transactions among Welded Parties with imbalance positions outside tolerance.

Broadly, submitters are concerned that the addition of these words could open a window to agreements outside of the MPOC dictating balancing arrangements in a way that could adversely affect Shippers.

MDL has since reconsidered the inclusion of the underlined words and offered to remove them from the Change Request. However, the change process set out in the MPOC does not explicitly provide for amending a change request after it has been submitted, so Gas Industry Co asked MPOC signatories whether they would agree to this adjustment to the Change Request. Although we have not heard from all MPOC signatories, one has rejected MDL's offer, so this Final Recommendation relates to the Change Request as originally submitted.

2 Submissions on Draft Recommendation

Five submissions on the Draft Recommendation were received from:

- Contact Energy Limited (Contact);
- Genesis Energy Limited (Genesis);
- Major Gas Users Group (MGUG);
- Nova Energy (Nova); and
- Vector Limited (Vector).

Copies of all submissions are available from Gas Industry Co's website at:
http://gasindustry.co.nz/work-programme/mpoc-change-request-b2b-14-february-2014?tab=2949

The submissions are summarised below.

2.1 Contact

Contact remains opposed to the Change Request.

It believes the Change Request introduces new concepts and processes external to the MPOC that have not been consulted on with users (prior to submitting the Change Request), and that do not promote the objectives of the Gas Act.

In particular, Contact believes the Change Request would:

- not put downward pressure on price, because it would introduce uncertainty about Balancing Gas trading and costs;
- raise barriers to entry, because potential Shippers are unable to trade Balancing Gas and do not have the tools necessary to manage their positions; and

- potentially favour MDL owners (who are among the few participants able to offer Balancing Gas); since the Change Request makes a subtle shift towards giving MDL more freedom to set the terms and conditions of Balancing Gas.

Contact suggests that MDL should leave it to the Balancing Agent to set the terms and conditions of Balancing Gas, subject to the MPOC principles.

Contact agrees to MDL's offered withdrawal of the proposed amendment to clause 3A.4(a), but believes that the changes to section 11.10, which also refers to MDL's terms and conditions, are also necessary. Also, that section refers to MDL's costs, and it is not clear to Contact what those may include.

2.2 Genesis

Genesis remains opposed to the Change Request.

It considers that the change would incentivise MDL to change the status of the terms and conditions, as:

- MDL does not currently comply with section 3A.4(a)(i), because it does not buy Balancing Gas at the lowest available price and sell it at the highest available price; and
- MDL has made it clear to Shippers that it wants to be able to prove the physical delivery of Balancing Gas. So Shippers expect that MDL would add this requirement to the terms and conditions for access to Balancing Gas.

Genesis considers that MDL's offered withdrawal of the proposed amendment to clause 3A.4(a) is a positive step.

2.3 MGUG

MGUG continues to support the Change Request.

It also supports further industry debate on the relationship of the Balancing Gas market and other markets, and that balancing charges are ultimately reflected in higher transmission charges.

2.4 Nova

Nova continues to support the Change Request.

While Nova understands the concerns of other submitters around balancing arrangements and the potential to link Balancing Gas to spot markets other than the BGX, it believe the issues are outside the scope of this Change Request and should be addressed separately.

Nova supports the Change Request because it believes that it improves accuracy, clarity and relevance of the current code and assists in the transition to B2B balancing.

However, Nova also agrees with Methanex that the requirement for, and relevance of the 13 October 2011 change request in respect of B2B balancing should be reviewed.

Nova agrees to MDL's offered withdrawal of the proposed amendment to clause 3A.4(a).

2.5 Vector

Vector remains opposed to the Change Request.

Vector considers that the matters that Gas Industry Co considered as not directly relevant to the Change Request (but deserving wider industry discussion) are indeed relevant because the Change Request would entrench or exacerbate their effect on the Gas Act principles. It notes:

> A change request which makes it harder to address issues which are adverse to the Gas Act objectives, or makes it easier to make future unilateral changes which may be adverse to the Gas Act, should be considered overall as detrimental to the objectives.

Vector expects balancing to increase significantly when B2B is implemented, as balancing corrections will occur over a shorter period. In that context, restricted access to the BGX will increase the negative impacts on customers. It believes the amendments are therefore inconsistent with the Gas Act principles.

Vector believes that the incorporation of reference to MDL's published terms and conditions into Section 3A.4(a) will give them equal weight to those principles. Thus, any amendments to the terms and conditions will effectively constitute amendments to the principles. So the Change Request will have caused a change to the status of, and relationship between, the terms and conditions and the principles.

Vector believes that changes to the terms and conditions should be subject to checks and balances that involve meaningful consultation.

Vector agrees with MDL's offered withdrawal of the proposed amendment to clause 3A.4(a) but objects to the process adopted. It considers that changes should not be amended by 'side letter' but should be withdrawn and resubmitted afresh.

3 Consideration of submission

3.1 Buying and selling Balancing Gas

The Change Request comprises many edits aimed at clarifying the relationship between MDL and its Balancing Agent in respect of Balancing Gas transactions. The most significant are:

- In section 3A.2 MDL proposes to add 'for and on behalf of MDL' to sub-clauses (a) and (b). MDL's rationale is that this will clarify that the Balancing Agent is not buying or selling for its own account, and will not obtain title in such gas transactions.
- In section 3A.4 MDL proposes to:
  - add in accordance with 'MDL's published terms and conditions and' in opening sentence of sub-clause (a), because the changes clarify that the Balancing Agent's purchases and sales must be made subject to MDL's terms and conditions for Balancing Gas;
  - amend Balancing Gas Puts/Calls 'entered into by the Balancing Agent' to 'made' in sub-clauses (a)(iv)(bb) and (c)(iv), delete 'by the Balancing Agent' in sub-clause (b), and delete 'entered into by the Balancing Agent' in sub-clause (b)(i), because the entity initiating a Balancing Gas Put or Call is not relevant; and
  - add 'between MDL and the counterparty' after 'passing of title' in sub-clause (b)(i), to clarify that the Balancing Agent does not obtain title in Balancing Gas Calls/Puts.
- In section 3A.5 MDL proposes to add a new provision stating 'All references in this Operating Code to Gas bought, purchased or sold by MDL shall include references to Gas transactions entered into by the Balancing Agent for and on behalf of MDL.' MDL's rationale is that this will ensure that the entity initiating a gas transaction on behalf of MDL does not change the effect of any other MPOC provisions.
- In section 11.10 MDL proposes to:
  - amend 'the Balancing Agent's costs' to 'MDL's costs' in the second sentence. MDL's rationale is that the costs for Balancing Gas are incurred by MDL itself; not by its Balancing Agent
  - amend 'Gas' to 'Balancing Gas' in accordance with the terms and conditions published pursuant to section 3A.4(b)' in the second sentence, and amend the third sentence to clarify that relevant

buy and sell spot prices are those 'available to MDL (or its Balancing Agent)' in the market 'for accessing and disposing of Balancing Gas on terms and conditions consistent with those published pursuant to section 3A.4(b)'. MDL's rationale is that Mismatch prices need to reflect MDL's (potential) costs for accessing or income from disposing of Balancing Gas during a day.

- In section 12.10 amend so that title is deemed to pass 'to MDL' instead of 'to the Balancing Agent' in the closing sentence. MDL's rationale is that Cash-Out Transactions are with MDL; not with the Balancing Agent.

Contact generally opposes these changes, and suggests that:

> Until such time as all parties have the ability to participate in the Balancing Gas market MDL should remove itself from the process and allow the Balancing Agent to set the terms and conditions subject to codified principles set out in the MPOC.

Contact is also concerned (in relation to sections 3A.4, 4.4, 12 and 19.6) that:

> Shippers have not previously been subject to MDL's costs and we are not clear what these costs may include. Reference should only be made to recovery of the Balancing Agent's costs that have been incurred.

Gas Industry Co is sympathetic to Contact's wish to have access to the Balancing Gas market, but we do not see that the proposed edits make that more difficult, or make it easier for MDL to ignore the principles of section 3A.4(a). Also, we note that the Balancing Agent is an agent of MDL, reports to MDL, and is subject to an operating agreement with MDL. It is not practical that the Balancing Agent should also be able to operate independently from MDL as Contact seems to suggest. The Change Request aims to clarify the relationship between MDL and the Balancing Agent, but it does not change it in any way.

Nor do we consider that operating costs are a significant issue. MDL is subject to incentive price regulation while its Balancing Agent (Transact Limited) is not, so MDL's costs should be no more of a concern that its Balancing Agent's costs.

Having re-examined our analysis in the Draft Recommendation in light of the submissions, we still believe that almost all of MDL's proposed edits clarify the relationship between MDL and its Balancing Agent, and so reduce uncertainty. However, on considering Vector's analysis – that the incorporation of MDL's published terms and conditions into section 3A.4(a) will give those terms and conditions equal weight to the section 3A.4(a) principles (for the Balancing Agent buying and selling Balancing Gas) – we acknowledge that this concern has some foundation.

In particular, we believe the inclusion of the words will mean that the terms and conditions will become a part of the MPOC by incorporation. Incorporating these terms and conditions into the MPOC goes beyond MDL's stated intention of clarifying that the Balancing Agent's purchases must be made subject to MDL's terms and conditions. Also, we question whether it is appropriate for an external contractual document (developed and created by, and for, MDL) to be given equal weight to the principles, which have been incorporated into the MPOC through a code modification process that involves stakeholder input.

However, Vector's concern appears to be more acute than this. It believes that the effect of adding the words 'MDL's published terms and conditions and' to section 3A.4(a) means that amendments to the terms and conditions (of buying and selling Balancing Gas) will effectively constitute amendments to the principles. We think that this is an extreme interpretation. While we accept that the added words do introduce some ambiguity over the relative weighting to be given to the terms and conditions and the principles, a plain reading suggests that the terms and conditions will still need to comply with the principles.

As previously mentioned (section 1.3) MDL has offered to remove the offending words. However, because the change process described in the MPOC does not explicitly provide for amending a change request during the process, Gas Industry Co considered it necessary to ask the MPOC signatories if they would agree to this. One signatory did not agree, so we must continue to consider the Change Request as originally proposed.

Because the proposed section 3A.4(a) edit was a concern of a number of submitters on the Change Request, our Draft Recommendation noted that it would help our analysis if practical examples of the kinds of situation that might arise as a consequence could be provided to us. Genesis suggested two situations that could arise.

Genesis considers that MDL does not currently comply with section 3A.4(a)(i) principle because it does not buy and sell Balancing Gas at the best prices, so MDL has an incentive to change this requirement. Also, it notes that MDL considers that Shippers should be able to prove physical delivery of Balancing Gas, and may wish to introduce a change to the terms and conditions to require this. Genesis considers these changes would be easier for MDL to introduce if the Change Request is implemented.

As Genesis observes in footnote 2 of its submission, the price and conditions of sale are related – if Balancing Gas is to have a stronger requirement for physical delivery than other gas, then it is likely to be valued at a premium price. This was addressed in section 6.5 of the Draft Recommendation where we concluded that:

> MDL buys its Balancing Gas on the BGX while other system users trade bi-laterally, or may use the emTrade or NZX markets.
>
> Whether Balancing Gas should be a different product to the gas traded on the other markets is a broader industry issue and not, in our opinion, an outcome the proposed edits would impose.

Genesis may be right that the Change Request would make it easier for MDL to introduce further distinctions between Balancing Gas and other gas. But we consider that this would be a very marginal effect, and unlikely to be significant in comparison to the wide ranging balancing issues that still need to be worked through by the industry, such as whether the ‘flow-on-nominations” regime provides sufficient incentives on system users to match physical flows to nominations. So we think that the effect of the current Change Request is not as significant as some submitters believe.

3.2 Likely effect of Change Request on the costs and prices

One of the Gas Act objectives (section 43ZN(b)(iv)) is that ‘delivered gas costs and prices are subject to sustained downward pressure’. Contact submits that the proposed change would not put downward pressure on price, because it would introduce uncertainty about Balancing Gas trading and costs. In addition, Vector expects balancing to increase significantly when B2B is implemented, as balancing corrections will occur over a shorter period. And, in that context, proposes that restricted access to the BGX will increase the negative impacts on customers.

To assess the likely effect of the proposed change we need to examine both the supply and demand dynamics of Balancing Gas.

Regarding the supply of Balancing Gas, we do not believe that the proposed change will alter the quantity of Balancing Gas available, or lead to suppliers of Balancing Gas requiring an additional premium for uncertainty. Changes to the Balancing Gas terms and conditions could affect prices, but we believe these could be made whether or not the Change Request is implemented. As discussed in section 4.1, we also consider that changes to the terms and conditions would need to comply with the section 3A.4(a) principles, and this applies whether the Change Request is implemented or not.

Regarding the demand for Balancing Gas, we agree with Vector that the introduction of B2B will likely increase the efforts of Shippers to self-balance (because tighter tolerances will apply and they will no longer have the benefit of the ILON grace period). However, this should result in more stable linepack and, since the need for Balancing Gas is determined by the state of the physical linepack, it should reduce the need for Balancing Gas. This situation also applies whether the Change Request is implemented or not, since B2B will be introduced as a result of a previous change that Gas Industry Co has already supported, and not predicated on the outcome of the current Change Request.

We agree with Vector that each Shipper will take more care to manage its own balance position, but since this should result in less extreme variations in linepack, we believe the residual balancing activity conducted by the Balancing Agent should decrease.

Drawing this together, our conclusion is that when physical situations dictate, MDL will procure Balancing Gas under posted terms and conditions that accord with the section 3A.4(a) principles and this will continue to be the situation whether or not the Change Request is implemented. While, the proposed addition to section 3A.4(a)(i) adds some ambiguity over the relative weightings to be given to the terms and conditions and the principles, we do not think that the overall effect on cost and prices is likely to be significant. In our view the current Change Request is unlikely to cause suppliers of Balancing Gas to alter their behaviour and/or alter the overall supply/demand balance, so we find no reason to expect that costs and prices will increase as a result of the Change Request. Also we think that MDL can increase the requirement for physical delivery of Balancing Gas (through the terms and conditions) whether the Change Request is implemented or not, and that the Change Request will not make it materially easier to do so.

3.3 Likely effect of Change Request on competition

Another Gas Act objective (section 43ZN(b)(ii)) is that 'barriers to competition in the gas industry are minimised'. Contact argues that the Change Request will raise barriers to entry because potential Shippers will be unable to trade Balancing Gas and do not have the tools necessary to manage their positions.

As noted earlier, the change request necessary to introduce B2B balancing has previously been supported by Gas Industry Company, and its implementation is not contingent on our support of the current Change Request. We can find nothing in the current Change Request that might alter a potential Shipper's ability to trade Balancing Gas or manage its balance position. The question of whether MDL might tighten the physical delivery requirements on Balancing Gas at some time in the future is not dependent on the outcome of this Change Request. Rather it will depend on how the introduction of B2B affects balancing behaviour, and the wider access discussions that are underway in the industry.

We agree that more competition to supply Balancing Gas is desirable, but we do not think that the current Change Request will reduce the already low number of Balancing Gas providers or present a new barrier to further participation in the market.

Contact is also concerned that the Change Request could potentially favour MDL owners (who are among the few participants able to offer Balancing Gas), since the Change Request makes a 'subtle shift' towards giving MDL more freedom to set the terms and conditions of Balancing Gas.

We would be very concerned if there were any move to restrict the number of suppliers of Balancing Gas. However, we do not think that the kind of subtle shift Contact perceives (eg the addition of the words '…MDL's published terms and conditions and…' into section 3A.4(a)) would be necessary or even helpful to achieving that outcome. If MDL had a mind to favour its own members by changing the terms and conditions of Balancing Gas it could do so whether the Change Request is implemented or not. However, we have no evidence of such behaviour and it would likely lead to its own substantive industry response.

Our overall view in relation to competition to supply Balancing Gas is that the Change Request would not introduce new barriers to competition. Also, there is sufficient sensitivity to this issue that all market participants will be alert to any changes and ensure that they are fully investigated.

3.4 Other matters

Prior consultation

Some submitters object to the absence of prior consultation by MDL on the Change Request. We note that the change request processes set out in the MPOC does not require the applicant to consult with stakeholders prior to submitting a change request. Section 2 of Attachment 1 of the Memorandum of Understanding (MoU) between MDL and Gas Industry Co does provide that:

> In the interests of promoting, if possible, a cheaper and more efficient process and given the contractual relationship/s between MDL and the applicant and other Parties, before submitting a Recommendation Request form an applicant must first have discussed the Proposed Amendment with MDL in good faith with a view to finding a mutually satisfactory resolution or position which the applicant can submit, with MDL's support, as a Proposed Amendment for consultation, consideration and decision.

However, this section relates to a situation where the applicant is someone other than MDL, so it is not applicable in the current Change Request.

Previous B2B change request

Several submitters suggest that we should re-examine the relevance of the 13 October 2011 change request in respect of back-to-back balancing. We agree that the broader balancing context needs to be kept in mind. Although a re-examination of a previous change request is beyond the scope of our contractual role in considering change requests, in our broader regulatory role as Industry Body under the Gas Act we will continue to review the efficiency of the transmission pipeline balancing arrangements.

MDL's offered revision to the Change Request

Although Vector agreed with MDL's offered withdrawal of the proposed amendment to clause 3A.4(a), it objects to the process adopted for dealing with the offer. It considers that changes should not be amended by 'side letter' but should be withdrawn and resubmitted afresh.

When MDL offered to withdraw the proposed change a number of possible process options were available, such as to:

1. reject the offer because it alters the original Change Request which had already been consulted on;

2. accept the offer because it would remove a significant source of complaint; or

3. check if the MPOC signatories had a unanimous view on whether to accept or reject the offer.

Although submitters argued against the proposed addition, we did not consider that this gave us authority to accept the offer. However, we thought it would be overly officious and wasteful to reject MDL's offer without checking if signatories all wished to accept it. So we chose option 3. Since there was not a unanimous view among MPOC signatories, we reverted to option 1.

4 Final Recommendation

Our Final Recommendation is to support the Change Request.